DOW THEORY LETTERS INC.

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1976 COMING UP, AND MY BEST WISHES TO ALL SUBSCRIBERS: I live by the principle that the powers above give us what we need, not what we want. If we get more than we need, it is because such gifts are given to make up for other personal lacks or losses. Thus, behind many ostensibly "successful" or rich men lies tragedy. The Kennedy's certainly had all the tragedy they needed, DeGaulle had a retarded daughter, Onassis's only son was killed in an air crash, Roosevelt became paralyzed, Lincoln suffered from nervous breakdowns, Lindbergh's only son was kisnapped and killed, Steinmetz was hideously disfigured, Dostoievski was an epileptic, Michaelangelo was a homosexual, Alexander the Great died in his 20's, Churchill knew defeat early in his career, and on and on throughout history.

We are on this earth to advance, to learn, to move from where we are to where the powers want us to be. Man grows through frustration, and he learns his lessons the hard way. Man can only learn through humility. Tragedy makes men humble. Defeat makes men humble. Loss makes men humble. But out of humility comes progress. Without humility there is nothing but vanity.

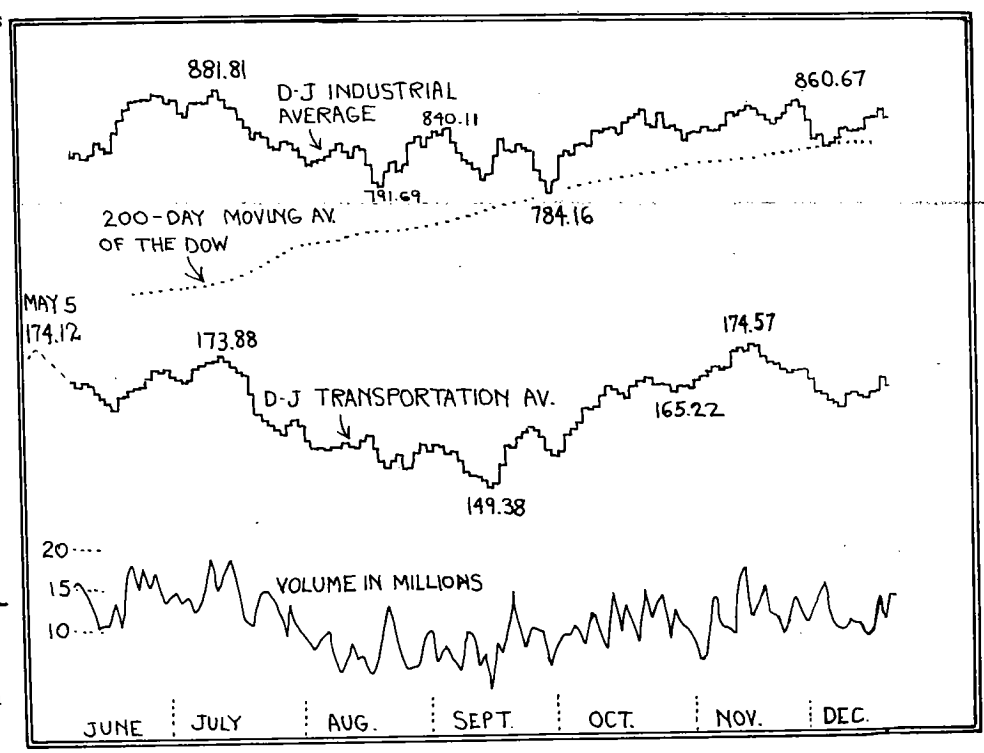
The stock market is a great humiliator of men. Many men have taken away more from Wall Street than they brought. Many others have been chastised and broken by the Street. The market seldom gives you what you want. Yet, if you treat it with humility it may well give you what you need.

Some men need money personally, others need money for their friends or for their business and employees, and still others need the feel of accomplishment or even success. The majority of people need to learn about life, even if it's only that "nothing comes easy" or (as Joan Baez sings it), "Nothing is given to man." By the latter I mean that we are given life, a heart and a brain. From that point on we must earn what we get. But we are given what we need in order to learn, to move, to progress. Wall Street is part of that process. Wall Street has always given me what I needed. It has seldom given me what I wanted!

THE PICTURE: The stock market has become overbought in a hurry. For some reason (which I go into later), it has put itself in a technical dilemma. If the market rallies up from here (through December), we're going to have real technical difficulties during January. Trouble in early January is usually nasty trouble, and it can lead to severe first quarter declines. There have been times in the past when the market has "worked itself out of" technical dilemmas such as the one it is now in (i.e., lagging A-D ratio, lagging most-active indices, odd-lot selling at fantastic peak with nowhere to go but toward less selling). But my guess is that the market is now moving into the trouble zone.

Just as 1975 opened with a big six months move on the upside, 1976 may be fated to play the tune in reverse. In other words, I haven't changed my cautious stance, and the warning put forth in my Special Warning Letter of November 26 still stands.

CONFLICT: Pity the poor stock market. Its "job" is to discount the future, to sift the rumors from the facts, to zero in on next month's headlines. The job is not easy today for the Free World may be nearing a critical juncture in its very philosophy.



In British Columbia the socialists have just been soundly defeated in what was billed as a "free enterprise-socialism struggle." In Australia a coalition of conservative parties won a smashing victory in the elections. In the US Ronald Reagan, representing Republican conservatism, moved ahead of Mr. Ford in selected polls. In an interview with a prominent US Senator, that Senator

 stated that in his travels around the nation he heard one constant complaint from the people: "Get the Government off our backs."

Is it possible that the Free World is moving away from the "Big Daddy" approach and back toward free enterprise? Is it possible, as the debt mounts up in every sector of the US economy, that the average American citizen is finally getting fed up? Is he exasperated to the point where he is ready to say so at the polls? All this the stock market is attempting to analyze, all this plus a thousand other concepts and statistics.

For instance, a prominent economist has stated that the prime rate could be at 12% by late-1976. A leading bank credit expert predicts that interest rates are coming down. If business does slow down, wouldn't that actually be bullish for the nation in that liquidity would build up? If a certain amount of deflation entered the picture, wouldn't this allow for the first adjustment in the US economy since the 1940's? But wait, isn't it true that many economic experts are predicting double-digit inflation for 1976 — even while other economists are predicting a pronounced drop in the inflation rate for next year?

It's axiomatic that when the picture ahead is fuzzy, the picture presented by the stock market is equally fuzzy. And the fact is that since last May, the stock market has been broadcasting the "foggy weather" message loud and clear (probably louder and clearer than any of us cared to recognize).

Where does all that leave us? It still leaves us with a primary bull market, a bull market that was confirmed as bullish last January. It leaves us with an economy that nobody can quite figure out (no two economists seem to agree on what is happening). And it leaves us with 25 million stockholders who, at this point, are more frustrated than satisfied.

Instead of last year's galloping inflation, we now have a "mixed diet" of inflation and deflation, a situation which I term dis-inflation. The money supply is up, the supplies of oil and energy fuels are up. But bricklayers in NYC have just accepted a fat cut in hourly wages, the prices of world raw-materials have been sliding with weekly regularity, and the average price of a home in San Diego County has just dropped ($300 on average from last month) for the first time in modern memory.

Where's the pie in the sky that was promised us for 1976, the Bicentennial Year? My own feeling is that we've been eating that pie ever since 1942, and we're now experiencing some of the indigestion that goes with a thirty-year house-party. I also feel that the great era of American "growth" is now in the slow-down phase and that many fundamentally bullish forces are now rolling over. This doesn't mean that there will be no more bull markets, and it doesn't mean that we're not in a bull market now. But it does mean that this bull market will run on Chevettes instead of Cadillacs and it will consume Big Macs instead of filet mignons.

This bull market may also have to settle for a total move of perhaps 400 Dow points instead of the 600 or more points that everyone so dearly wants (or needs). The 1921-1929 bull market advanced the Dow a total of 317 points while the succeeding 1932-1937 bull market boosted the Dow only 153 points. Nevertheless, both bull markets produced profits and both bull markets produced their share of pleasant surprises and frustrations. The bull market that began in late-1974, in my opinion, will be more like 1932-37 than 1921-29.

What we have so far is a bull market bottom for the Dow at 577.60 on December 6, 1974 (125.93 for Transports), and a top for the Dow at 881.81 on July 14, 1975 (174.57 for Transports). Thus, gauged by the Averages alone the Dow Industrials have produced a gain of 304 points in the bull market while Transports have given us a gain of 49 points.

The big question now is whether the reaction from Dow 881.81 to the 784.16 (see chart on page 1) is going to suffice for a full correction, or whether that first leg down is going to be followed by a second down-leg which will take the Dow below its October low of 784.16, perhaps substantially below that level.

For a while, it appeared that the September-October "bottom" (downside non-confirmation and all) was sufficient to provide a base for the Dow, a sort of "launching pad" that would support a late-1975 move to about the 1000 level. Personally, I thought the market was shaping up that way, but then I got late-word from the market, and I had to change my script. On November 26 I sent out the Special Warning Report in which I drew subscribers' attentions to the "double non-confirmation" in the Averages. These powerful reversal patterns are rare, but when they do appear I act on the principle that discretion is the better part of valor. I decided to tip-toe (discreetly) out of this market on the theory that we could ultimately be running into more "correction" than I would care to have my subscribers go through (with full portfolios).

Most secondary corrections in history have assumed the form of at least two downward legs separated by a good rally. Glancing at the page 1 chart of the Averages, note that Industrials declined to an August 21 low of 791.69, then rallied to a September 8 high of 840.11. This was followed by a second rather short downward swing to the October 1 low of 784.16. That appeared to me (at the time) to be all the correction that was necessary.

Then came the advance to the November 28 peak of 860.67 — and the double non-confirmation. Following the double non-confirmation, I revised my thinking to at least include the following possibility. The move down from the July peak of 881.81 to the October 1 low of 784.16 formed leg A of a much larger A-B-C correction. The rally from 784.16 to the November 28 Dow peak of 860.67 represented the intervening rally. The decline from 860.67 represents the beginning of the final leg down in this correction, a down-leg that is fated to break below the October 1 low of 784.16.

"Blast it, Russell," you retort, "with that kind of scenario this market could run up into Christmas, top out in early January, and then slide down to a final low in February or March. It could be the end of the first quarter, 1976, before we hit a real

secondary bottom" And I'll concede that there is a very real possibility that we could see just that kind of action. Remember, the market isn't a giant honey pot, sitting there for you and I to scoop profits out of whenever we want them. It's more like a rat maze, and our job is to try to work our way through the deceptive passages, the fake entrances — and somehow find the light at the end of the maze.

From another standpoint, the current situation is worth studying and mulling over. The average investor is now hoping that the news will somehow change, that it will turn rosy and promising. This change in the economic outlook is supposed to move the market higher. All I can say to that kind of thinking is "Hogwash." Wall Street doesn't work that "logical" way. The fact is that the Dow has been stalled in the 785-880 area for seven months. If investors would not buy stocks previously at Dow 860 or 880, why are they going to buy them in any meaningful way now (in the same area)? The answer is I don't think they are. Consequently, I feel that the market is going to have to go lower before this episode is over. Seasoned investors don't buy on news, they buy on the basis of values. And if they think stocks are basically uninteresting at 850 on the Dow, they are going to want lower prices before they enter in a real, "heavy accumulation" manner.

That kind of thinking, I believe, is what could produce the final down-leg in this correction — and the lower or "bargain" prices which will bring the big money in. It's axiomatic, in fact, that big money will always enter the market at some given price level. That level is the level at which the big money believes stocks offer real value. We don't seem to be there yet.

BREADTH: As I see it, the basic problem with this bull market is now breadth, the reluctance of the majority of issues to follow the D-J Industrial Average to higher levels (or towards 1975 recovery highs).

A glance at the accompanying daily chart will serve to point up this technical problem. From December, 1974 to mid-July, 1975, the price and breadth action, taken together, was magnificent. Then came the correction from the July 15 peak to the October 1 low. On that decline the A-D ratio gave up almost 7 points. On a comparative basis, the 97 point decline in the Dow (July 14 to October 1) was considerably less damaging. But it was the action following the October 1 lows which has proved to be such a technical stumbing-block.

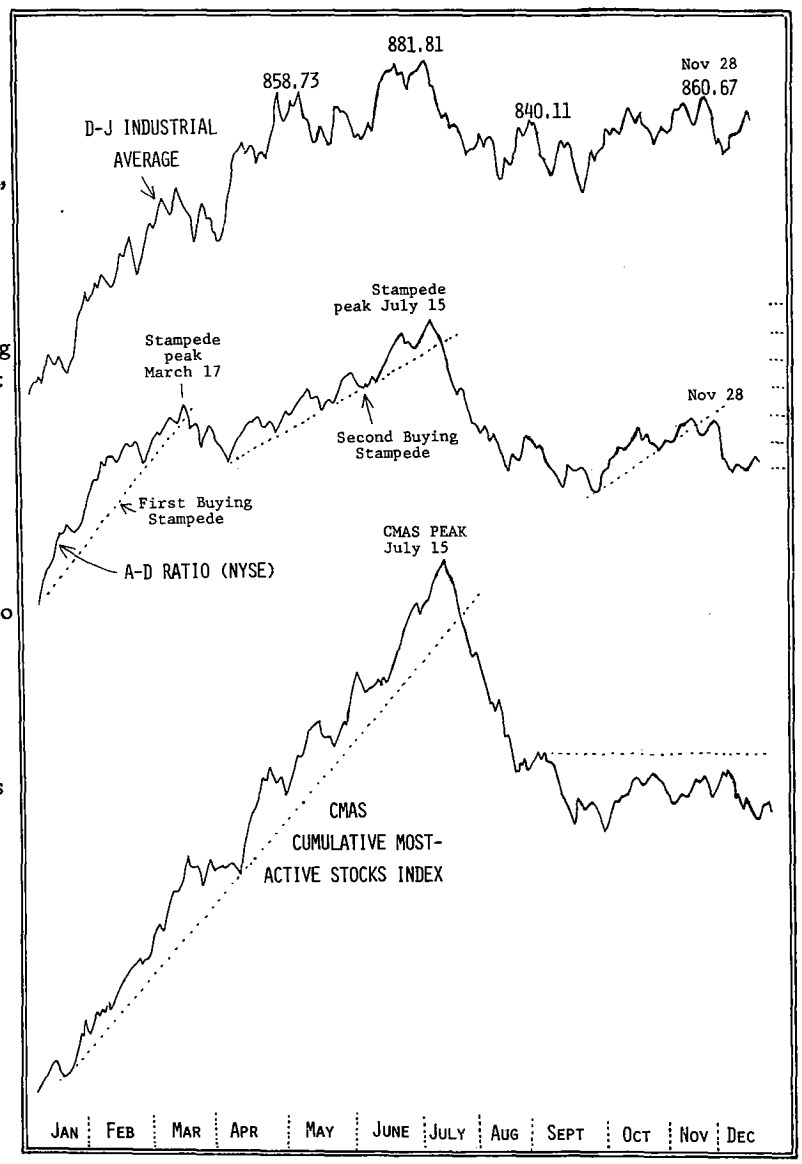
On November 28 (with Industrials at their recent recovery high of 860.67) the Dow was within a mere 21 points of its 881.81 recovery peak of 1975. Yet glancing at the A-D ratio, we see that this indicator has been discouragingly sluggish. On the same November 28 trading session, the A-D ratio was almost 4 points under its comparable 1975 recovery high. The chart graphically shows the discrepancies in the two indices at the November 28 points.

Now look at the recent December lows. Note that the Dow Industrials was at the 818 level, still within "shooting distance" of its 1975 recovery peak. But note also that at the December low the A-D ratio was only 1 point from its October low and at roughly the same level as it was last February.

The rally since the December lows has merely continued the discouraging relationship between the Dow and the rest of the market as gauged by the A-D ratio. Note that since early December the Industrials have pushed into the 850's, but the A-D ratio has hardly budged off its December low. It's a problem that will not "go away."

What is the market telling us through its recent price-breadth discrepancies? I feel that Wall Street is saying that the earnings improvement which the market foresees for the 30-Dow Industrials (in the year ahead) will be hard pressed to rub off on the great majority of other NYSE issues. While it is true that the Dow 30 represents about 25% of the value of the entire NYSE, there is still that other 75% that seem to be lagging or confronting various business problems. When this kind of technical market situation has occurred in the past, the market has usually declined to the level wherein it has wiped out the movement that produced the discrepancies.

One point may be well worth mentioning at this time. So far during October-December, we have had lags but



no upside non-confirmations on the part of the Dow and the A-D ratio. Note on the chart that on the rise to the November 28 Dow peak of 860.67, the A-D ratio did push up to a new confirmatory high. As a rule (based on past price-breadth history), important market declines are preceded by recovery highs in the Dow unconfirmed by the A-D ratio. The break in early December occurred without such a non-confirmation, but the break did serve to send the A-D line considerably lower. A new recovery high (above 860.67) by the Dow now would probably produce a price-breadth non-confirmation. Therefore, I would take a new Dow high above 860.67, unconfirmed by the A-D ratio, as a very bearish indication. We'll watch for that in the period ahead.

The question might be asked, "What happens if the market turns down here without an upside price-breadth non-confirmation?" My answer is that there have been instances in the past when the market has had a bad spill without a non-confirmation on the part of the A-D ratio. That could happen here, and if it does, I won't argue with Wall Street. To the man who is holding a declining stock, it makes little difference whether the market has provided him with a "perfect sell indication" or not. His losses are just as real either way.

At the bottom of the chart we see the A-D line of the most-active stocks on the NYSE. This chart is an 8-day moving average of the daily most-active stocks' pluralities. This cumulative most-active line (CMAS) has been almost as laggard as the A-D ratio on the rally from the December 9 lows. I watch the CMAS carefully, because it frequently provides trend indications ahead of any other indicator. So far, CMAS is saying that the market rally has been a lackluster one, and that the path down is easier to travel than the path to the upside. I consider CMAS to be a sort of A-D index of "big money," and so far it must be conceded that investment money has not been pouring into Wall Street during December, 1975.

CONCLUSION: In my "double non-confirmation" studies of the past few Letters I explained how the Industrial Average was the weaker Average from the period of the September-October lows to the November 17 highs. From there, it was the Transports that turned weak into late-November (and they are still laggard). Now the A-D ratio has joined the list of laggard indicators as has CMAS. All of this would seem to spell trouble in 1976 unless the character of this market changes radically in the period ahead (and if that happens, it will be duly reported here).

HIGHS & LOWS: I have run the NYSE high-low figures a dozen different ways over the years, and I have never been completely satisfied with any single technique. In a strong advance, many issues will push up to new highs for the year, and as the advance progresses an increasing number of issues will join the new high parade. This is the characteristic of a powerful rise. On the other hand, in a market which is running on "revolving strength" (and increasing distribution) the advance will fail to generate a consistant increase in new highs for the year.

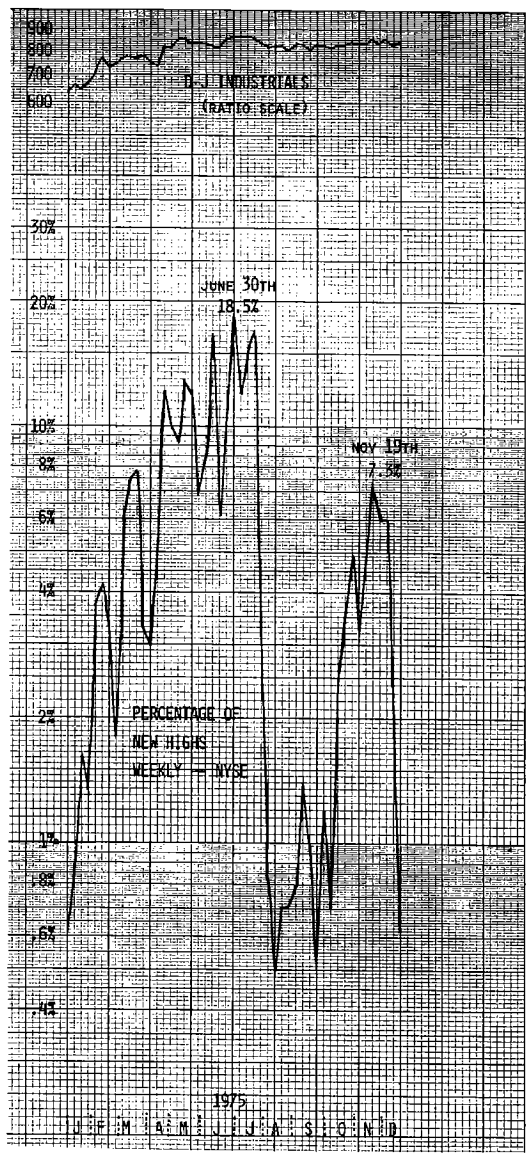
The M/G Financial Weekly now publishes a running tabulation of new highs and new lows (weekly) on the basis of the past 52 weeks. This is an improvement on the current Dow-Jones method which shows new highs for a period of up to 14½ months, and then in March they start again with stocks that have made new highs or lows over the last 2½ months.

An article by Steve Buhl in a recent issue of the Financial Weekly points up a new and very useful method of showing the highs and lows. Buhl puts the running 52 week highs (and lows) in the form of a percentage of stocks traded for the week. Thus if there were 80 new highs for the week, 80 is divided by the number of issues traded (say 2025 issues were traded) and the resultant figure shows that 3.9% of the issues traded that week registered new highs.

Buhl runs his figures on a 10-week moving average, but I prefer to work with the actual weekly percentages. I include a chart showing the weekly percentages of new highs (weekly figures divided by total issues traded for the week), and the results are most interesting and, I might say, dismaying. The peak of new high percentages for the year 1975 was registered on June 30 with the Dow closing at 873. On that week 18.5% of all issues traded on the NYSE hit new highs.

The percentage then dropped to .5% on September 22. The market rallied again, and on the week of November 17 (with the Dow back at 854) the second new high peak occurred at 7.3%. This was less than half the June peak and a poor showing. From the November 17 peak of 7.3%, the new high percentages dropped off to .6%, and this occurred with the Dow in the 833 area (on December 13).

To top off the problem, the new low percentages (not shown on chart), after being below 1% all year, moved up to 2.7% in mid-December, thereby sur-



passing the December new high percentage by a wide margin. As I see it, this study is saying that buying power is running out of this market (as the new high percentages collapse) while selling pressure is coming in (as the new lows percentages expand). That does not bode well for Wall Street and it underscores my own cautious stance.

PROFITS & LOSSES: I can't really prove it, but it has always been my suspicion (based on talks with hundreds of investors and traders) that most people lose money in the stock market (and the bond market, as well). There are any number of reasons why they lose money, but in general I would say that people simply do not understand what they are doing or why.

For instance, if you have say $100, 000 or more, you should probably cease thinking in terms of speculating. The reason is that you are probably in a higher tax bracket, and you are putting up your hard, after-tax dollars to make possible short-term profits (which will be taxed again). That's a stupid risk, in my opinion, and not worth the trouble. The man who has accumulated say $100, 000 or more should think in terms of making that capital work for him. He can do this (1) by utilizing the fantastic power of compound interest, and (2) by taking major equity positions at the beginning of primary bull markets, or directly following corrections in a primary bull market.

Here's another thought which I seldom see expressed. Young people tend to go into debt, and in that way they allow compound interest to work against them. The greatest assets the young person can have (assuming he wants to accumulate money) is brains and time. If you are reading this, I'll assume you have brains. But compound interest works through time. Therefore, I always tell young people (1) stay out of debt, (2) move most of your money into high-yielding situations, and let those situations compound. Today, you have the highest interest rates since the Civil War working for you. Who needs to shoot craps! You simply don't need to speculate recklessly at this time.

Another thought. People often, very often, get rid of their money through unconscious guilt. I've seen people who have inherited money or who have been very successful in their own business, literally throw their money away in the market. Such action is almost always a result of guilt ("I really don't deserve this, I didn't really work to get it, " or "I don't deserve this success; I'm no better than the next guy."). It's all right with me if you want to get rid of your greenbacks and assorted assets, but why not do some good with your "casting off activities," and simply donate the money to some good cause like medical research or the local library?

In other cases, people "play" the stock market out of sheer boredom or because they can't interest themselves in any pursuit unless it has the thrill of winning or losing (money) connected with it. Being in the market for thrills is a poor excuse for trading, and I don't recommend it. Ultimately, the thrill seeker will place himself in a position of intense pressure (usually heavily margined or heavily short), and then he'll get his greatest thrill of all — going to the cleaners!

So again, let me suggest to subscribers that you search your mind and your emotions for the real reasons why you are in the stock market. If those reasons are basically sensible, realistic, humble, meaningful, then you should have an excellent chance of doing well with your investments. Remember, the great investment opportunities are seldom understood or appreciated at the time. In 1942 or 1949 few people understood that the stock market represented a reservoir of extraordinary values, values that were fated to rise for decades to come.

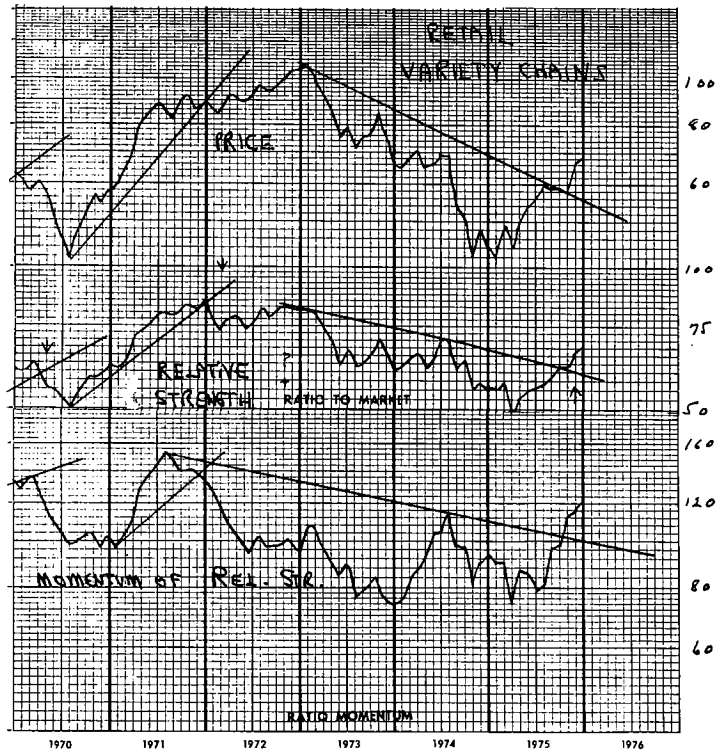
Here in 1975 it could well be that debt instruments, particularly high-grade debt instruments, represent the great values. It could be that Aaa-rated bonds and the like are on the bargain table compared to any period within modern memory. Certainly, the compound effect of bonds which yield 8% to 10% is staggeringly rewarding. Along these lines, I strongly suggest that my subscribers purchase (and study) a compound interest rate table such as the kind which can be furnished free from almost any neighborhood bank (Letter 630 included a compound interest chart; you can also write for free "Compound Interest Tables" pamphlet from Union Carbide, 270 Park Ave. NYC 10017).

RELATIVE STRENGTH: Relative strength is a concept which, for some reason, very few investors really comprehend. The principle of RS is simple enough. Through good markets and bad, there are always certain stock groups and certain stocks that will outperform the market. This outperforming-type action can easily be computed via ratios of the stock vs. the general market (i.e., the general market as gauged by any good stock average). Thus, if we want to watch the RS performance of say the Chemical Group we can simply divide the price of the chemical group by say the S & P Stock Average (on a weekly or a monthly basis).

It is important to understand that RS performance shows us something about the accumulation or distribution which is taking place in a stock. When we chart the RS performance we will get patterns of sideways movement (meaning the stock is acting no better or worse than the market) or we will get patterns or rising or declining lines (meaning the stock is outperforming or underperforming the market).

It is well to realize that RS performance usually last for an extended period of time. Thus, a RS rise (or decline) may last anywhere from six months to a year and most often for a year to three years. The logic behind this is simple enough. It generally takes six months to accumulate a stock or group of stocks and at least as much time to distribute those shares. Therefore, a quick accumulation and distribution should take at least a year but more often two or three years.

This means that RS trends form the basis for intermediate to long-term investing plans. If a group such as Retail Variety Chains turns bullish (see chart at right) one can purchase these stocks and hold them perhaps a year to a few years or until the RS of the group turns down. This is the least recognized and most valuable factor in the RS concept — namely, that these RS trends usually last for a long time.



Now here are a few other concepts about RS which should be fixed firmly in mind. First, just because a group is turning up or rising in RS does not mean that the actual value of the group is increasing. In a bear market, the group might merely be declining at a lesser rate than the market (this would, of course, show up as rising RS).

Second, I never like to buy a stock in a group which is evidencing declining RS, regardless of the appearance of that stock. By the same token, rising RS in a group is usually bullish for all the stocks in that group. The reason is that whatever good affects the group, that same plus list of factors tends to affect all the stocks in the group. The same is true when RS is turning down for a group (i.e., all the stocks in the adverse group will be affected negatively).

Third, when a long trend of RS is reversed to the upside or downside, the price action often disconcertingly whips momentarily in the opposite direction. This seems to be the market's way of resisting a new force, and it can prove to be a very confusing matter for the new investor. For instance, when gold RS broke (see Letter 619), the group turned most definitely bearish on a RS basis, and this was pointed out in these reports. Nevertheless we had a disconcerting counter-trend rally in gold before they started to fall apart in earnest during the latter part of 1975. I must admit that my first reaction was that perhaps the RS chart was wrong, but no, the chart was correct and the selling interpretation was in order.

Finally, it has been my experience that once a group tops out in RS, you can forget that group for a long while — and more profitably put your attention somehwere else. I recognize that investors tend to form emotional attachments to stocks that have performed well for them ("I simply love DuPont, it's such a progressive company"). But once RS turns down, the technicals are saying that the market has fully discounted the best of the picture in that particular stock or group, and from then on it's a case of distribution and in due time lower prices for those stocks. When RS turns down, it means that the big sponsorship, the quality sponsorship, is over. That means a bear market for the group, and there is no other way to look at it. Of course, the exact opposite can be said of a group when RS has turned up, and those are the stocks to be in (assuming that a primary bull market is in progress). (Var. Chain chart courtesy of Ray's*Signals, 43 Lake Ave. Montrose PA 18801).

LATE NOTES: My daily chart of the 7-3/4 Treasury note has just broken out on the upside for a third wave up since September. This suggests to me that money rates are coming down. Why is that? Because business is poor, and the demand for money isn't there yet. My advice about closed-end bond funds, T-notes and better to top-grade bonds still stands. I like them.

I don't yet know how today (December 22) will end, but if there are 320 more declines than advances on the NYSE and volume is below 17.7 million for the day, then my negative volume index (see Letter 646, page 3) will break to a new low for the year. I would take such an event as bearish. It would mean that it takes volume to put stocks up, but that they decline just as fast (or faster) when volume drops off. As I said, that kind of action is plain bearish, there are no two ways about it.

GOLD: My relative strength chart of bullion compared with the gold shares shows that since July the market has favored bullion over the shares. This has been a steady trend, but there were three lower tops in the ratio , one in 1973, one in '74 and perhaps one now. At any rate, the jump in the gold shares last week was on news, and I am never "in love" with market moves that occur on a news event (i.e., the IMF-BIS arrangement whereby the IMF could sell gold to the BIS, and the BIS could sell it to the Central Banks).

At any rate, as I suggested they might (see last two reports), gold shares popped upward with the leaders adding 10% to 20% to their depressed late-December prices. The move came from obvious "double bottoms" in ASA and HM, so that there was a technical basis for the move. I still see golds as trading vehicles only, and I do not believe a primary bull market in bullion or gold shares has started. Traders who bought at the lows now have profits. But I would not chase them here.

LATE, LATE NOTES: With Value Line's broad, unweighted Averages now at a nine-month low, I would like all my subscribers to be very careful (I assume that most of you take these Letters seriously, however, and have already been careful — and that means light as far as holding stocks are concerned).

Finally, I want to wish all subscribers a most healthful, satisfying and successful New Year. The next Letter will be mailed after the Holidays on January 7.